Equity Value Analysis

Netflix

Financial Statement Analysis 6SSMN352

Netflix Inc.

EXECUTIVE SUMMARY

Strategy, Industry and Peer Analysis:

- Rapidly growing and profitable industry
- Low barriers to entry, leading large companies to enter through new or joint ventures
- Netflix having to deal for the first time with direct substitute services

Accounting Analysis:

- Accelerated amortization is based on assumptions for the future, implying uncertainty in the value reflected by the asset turnover ratio
- Single-revenue stream leads to high leverage, prone to domination by conglomerates

Ratio Analysis

- High cost of revenues driving net and gross profit margin below the peer set's
- Highly leveraged position justified by growing subscriber count and successful conversion of debt to assets
- Negative cash flow from operations as a result of large investment in content production
- Steadily increasing positive sustainable growth rate due to growing domestic & international revenues

Cash Flow Analysis:

- Inflows are restricted to financing activities.
- Increasing leverage puts in question sustainability of cash flow approach

Credit Analysis & Debt Rating:

- Assigned credit rating: Baa, with a speculative outlook
- Reflects a company operating in a growing and prolific industry
- However, precarious financial position puts in question ability to compete with new entrants

Forecasting and Valuation:

- Emerging markets and increase in internet coverage worldwide prove beneficial to future sales growth
- Growing competition from production companies and conglomerates (e.g. Disney, Apple, Amazon)
- Margins are below peer but enterprise value remains high, reflecting an overvaluation of the company on the market

RECOMMENDATIONS:

Recommendations:	Moderate Buy
Current Price:	$354.61
Target Price:	$402.93
Difference to Current:	13.62%
52w High:	$423.21
52w Low:	$231.23
Listed Exchange:	NASDAQ
Ticker:	NFLX

COMPANY FACTS:

Domicile:	California, USA
Founded:	1997
Industry:	Over the Top
Sub-sector:	Video-on-demand
Employees:	Approx. 7,100

KEY METRICS

ROE:	27.46%
Net profit margin:	7.66%
Cash Ratio:	.58x
Free Cash to Debt:	28x
Tot debt / Tot Equity:	197.76x
CAGR of sales:	26%
P/E:	99.86x
Credit Rating:	Baa

NOTES:

- All information in the report was obtained from Bloomberg and the annual statements of Netflix, Viacom and their respective peers, unless specified

Corporate Profile

Netflix Inc. originated as an online DVD rental provider. Since 2010, its focus shifted to online streaming: in-house productions and licensed third-party movies and tv-shows. Netflix went public on May 22nd 2002. Their internationalisation process began in Canada in 2010. In 2016, Netflix announced their global expansion to over 130 new territories, 190 in total.

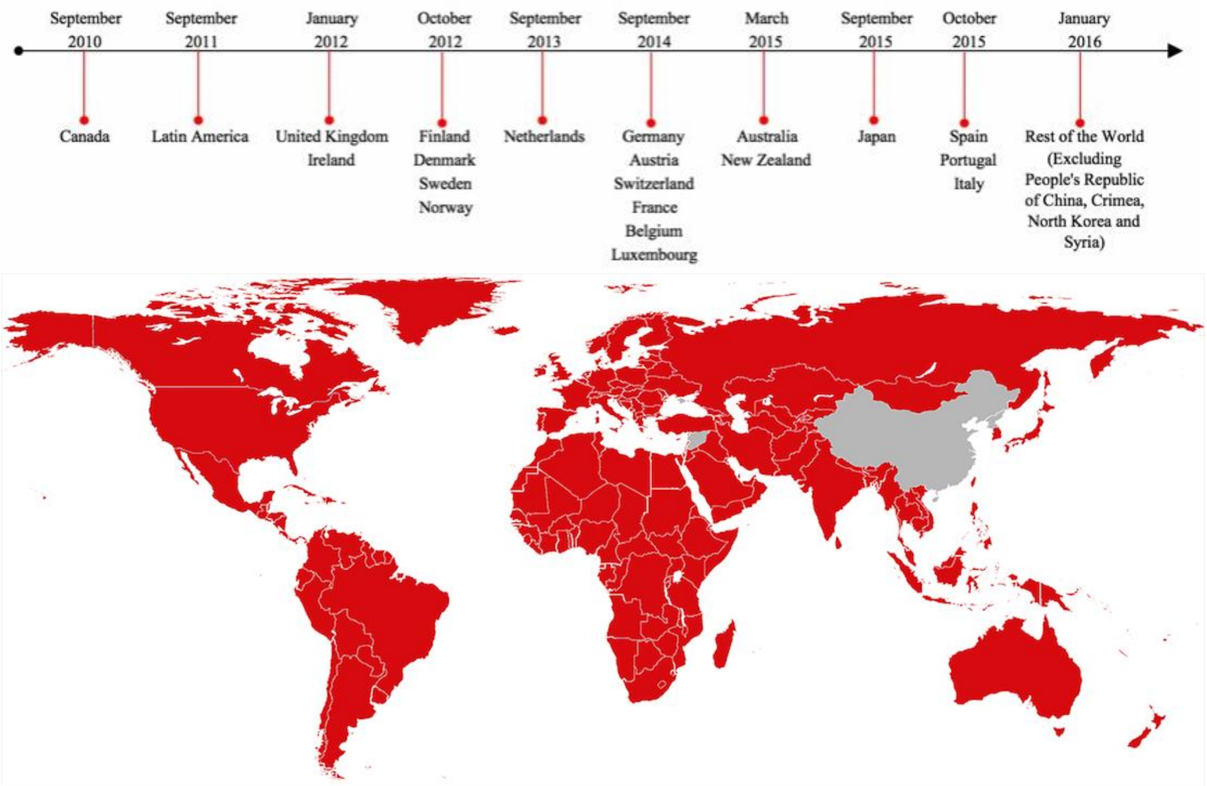


Figure 1. Netflix Internationalisation and Availability by Countries

Their operations (subsequently financial information) are segmented into three principal subsets:

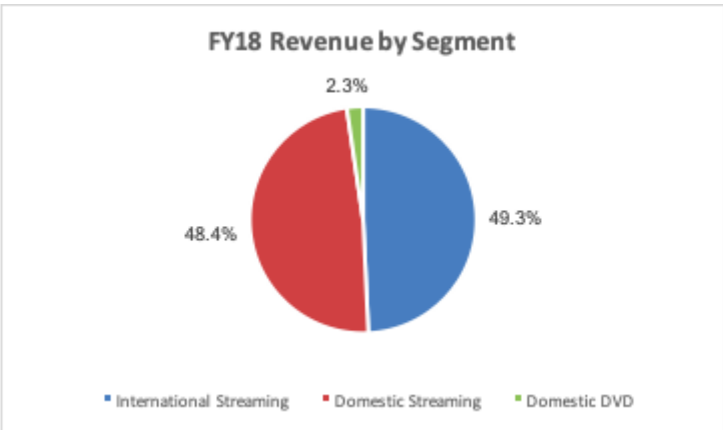


Figure 2. Revenue by Segment

The increased accessibility and applicability of online business models has lowered barriers to entry in this market for new players; moreover, the main players are large U.S. companies with vast influence over the media streaming market, making Netflix's environment fiercely competitive and volatile.

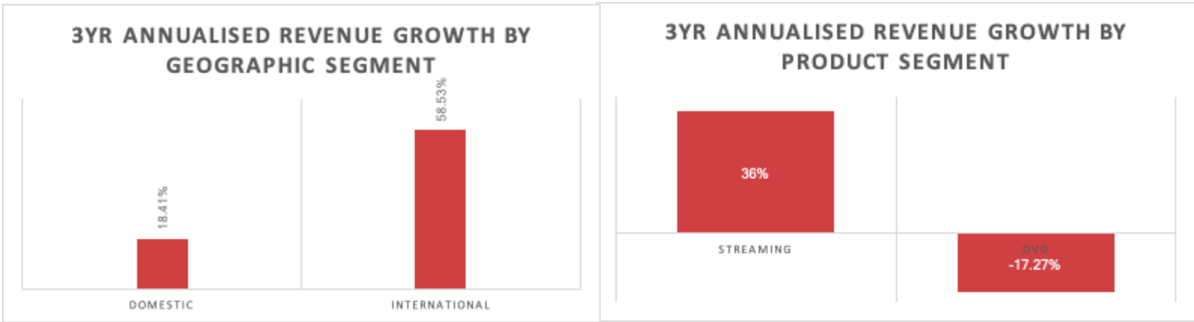


Figure 3. Revenue Growth by Geographic and Product Segment

As their operations and cash flows are shifting to the online sector, Netflix continues to compete for user's attention online. As a result of their risky growth strategy Netflix has historically had volatile market prices. In today's market conditions, the firm faces growing industrial challenges and investor concerns regarding the access and right to use content, increasingly being appropriated back by original content creator networks (Disney, HBO, Paramount etc.).

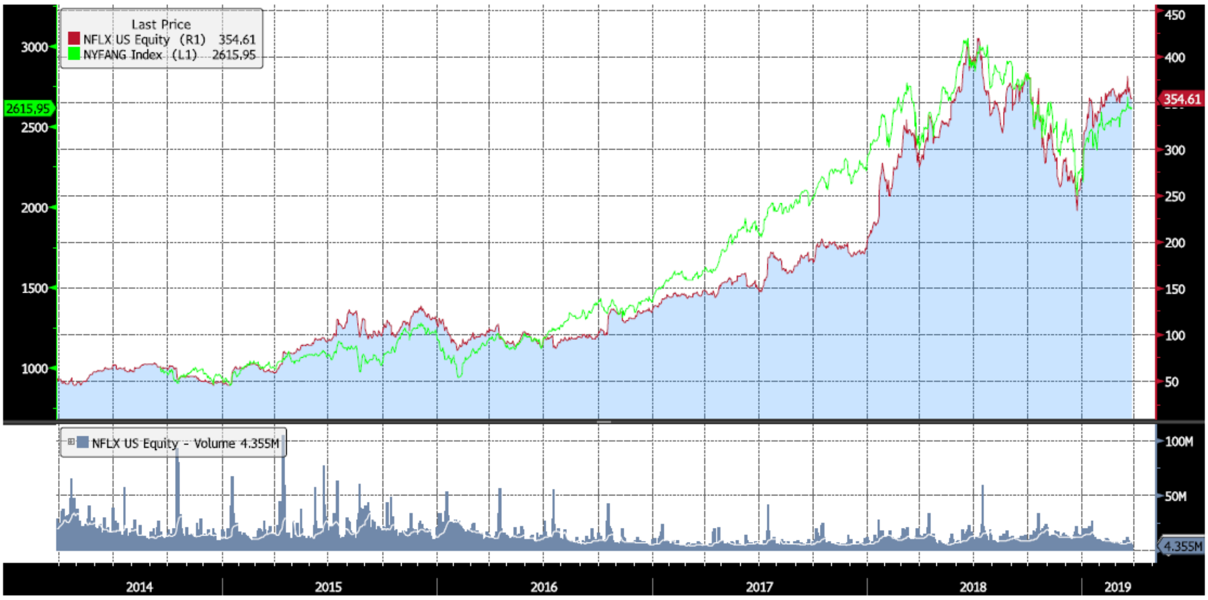


Figure 4. Netflix Share Price

Peer Set Assessment

Weight		Netflix	Viacom	CBS	Alphabet	Disney
20.00%	Entertainment Content Industry Specificit	4	4	4	2	3
20.00%	Content Geographic Availability	4	4	1	4	1
20.00%	Online User Size	4	4	1	4	1
20.00%	Content Diversification	4	3	3	2	4
10.00%	Perceived Overall Quality	4	3	2	3	4
5.00%	Platforms	4	4	4	4	4
5.00%	Subscription-based Revenue Model	4	1	2	1	1
100.00%	Totals	28	23	17	20	18
	Weighted Totals	4	3.55	2.3	2.95	2.45
	Ranking		1	4	2	3

Weight		Netflix	Viacom	CBS	Alphabet	Disney
0.1	Revenue Growth YoY %	0	-37.49	-29.1	-11.66	-27.29
0.05	EBITDA Margin %	0	12.55	11.85	18.86	18.33
0.05	EBITDA Growth YoY %	0	-74.77	-83.8	-64.97	-76.78
0.2	Total Debt / Total Assets %	0	2.5	6.55	-38.17	-18.71
0.2	Return on Invested Capital	0	0.3	6.49	0.69	1.64
0.1	Total Debt / EBITDA	0	3.17	3.04	6.04	4.92
0.05	P/E TTM	0	-91.67	-91.5	-75.41	-83.06
0.05	Return on Assets	0	2.08	4.14	8.87	4.87
0.2	Return on Equity	0	-3.56	57.57	-8.89	-5.25
	Ranking		1	3	2	4

Peer set has been selected based on qualitative and quantitative factors. Additional emphasis is put on qualitative factors due to the ill-defined nature of the industry. Netflix is commonly compared to high-growth technology companies (FAANG); however, they are currently facing competition from the traditional entertainment industry making it difficult to identify direct competitors for the Company. Viacom is selected as closest peer due to congruent qualitative factors, comparable financial structure and strategic industry outlook.

Industry Analysis

Market Competition
Market is ill-defined, competitors attract users by amalgamating services and features, competition is local and global

- Few international streaming providers, concentrating competition
- Notable entertainment competition in domestic market; adoption resistance from highest growth potential segments (Asia-Pacific) due to local preference for ad-supported alternatives
- Demographic differences, cultural stigmas and viewer preferences affect adoption
- Diversified firms (e.g. Amazon) offer bundle memberships (e.g. Amazon Prime) to incentivise membership by providing services which may go beyond content streaming
- Overlapping industries are ultimately competing for consumers' free time

Bargaining Power of Suppliers
Non-Original is sourced externally via licenses

- Film Studios and TV Networks – main suppliers
- Contractual Obligations of varying lengths and rates are incurred – deal terms established by content provider
- Upon maturity, content becomes unavailable unless licensing is renovated
- Current content (e.g. Marvel Studios) on Netflix is being re-appropriated by original content creators as competitive services enter market
- Netflix is now relying less on external content through in-house production of Originals, and content acquisition from smaller independent studios

Bargaining Power of Buyers
Competitive alternative services result in low switching costs for consumers

- Content specificity varies depending on platform (e.g. ESPN+ vs. Hulu+)
- Competitive membership pricing schemes
- Consumer preference for platform-specific content will determine service choice
- Not all content is mutually exclusive to platform
- Netflix is acquiring an array of content to cater to as many user groups as possible

	USD/Month
Netflix	
Basic	9
Standard	13
Premium	16
Viacom	
Through SlingTv (US)	25
Through DirecTV	From 50
PlutoTV	FREE
Disney	
ESPN+	4.99
Hulu+	11.99
CBS	
All Access	9.99
Alphabet	
Youtube Premium	12

Figure 5. Membership Pricing

Threat of New Entrants
OTT (Over-the-top) market is a growing sector and profitability of Netflix's business model has been replicated by competing incumbents and niche alternatives

- Industry is ill-defined, as entertainment film studios transition to digital content services
- Many niche alternatives emerging (e.g. Fandor, Meerkat)
- Competition within each geographic segment, as well as across segments
- Netflix mitigates these effects using their global presence, strong brand image, current market leader position, and content diversification (e.g. language, variety)

Threat of Substitutes

Netflix competes (in)directly with OTT competitors, and abstractly with digital media offerings which draw from consumers' free time

- ❖ Entertainment substitutes come in many forms (e.g. social networks, live-streaming platforms, YouTube)
- ❖ Content piracy is a major concern as it is poorly regulated online; thus, Netflix content can be accessed for free from alternative sources
    - o Netflix mitigates these effects by incorporating platform-specific features (e.g. smart downloads, and Dynamic Optimiser) and by making their membership more attractive through the vast content library

Strengths

1.Netflix can leverage strong brand image and international presence
-190 countries with over 139M users worldwide
-Used to leverage/incentivise content partnerships
-First mover advantage / market leader

2.Sourcing locally, distributing internationally
-Content diversification based on region and partnerships
-Subtitles and audio in many languages
-Content accessible from any device (smartphone, laptop, PC etc.)

3.No commercials or advertisements

4.Award-winning Netflix Original content exclusive to platform (Cook, 2019)

5.Offer greater creative control to producers than traditional TV stations or movie studios (Patel, 2018b; Waterson, 2018)

6.Diversified product offering
-Various membership plans (SD, HD, 4K)
-Various content available
-Third-party (e.g. Vox, Conde Nast Entertainment, Fusion Media Group) (Patel, 2018)
-In-house (Netflix Originals)
-New interactive films "Bandersnatch"
-Exclusive deals (Barack and Michelle Obama will develop ideas for potential shows)
-Brining anime to international viewers, tapping into asian markets whilst expanding the content to other countries

7.Solid profitability figures and retained earnings for sustainable internal growth
-Acquire up-and-coming content
-Produce in-house content
-Internalise value and competitive advantage from content through licencing

Weaknesses

1.Business model originated as a content re-distribution platform; profitable business model which is being contested and imitated by original content creators
-Forced to licence external content (high LT contractual obligations and costs)
-Growing number of platform-exclusive content is needed to maintain competitiveness
-Major industry competitors (Disney, Viacom, AT&T) are reappropriating content rights to their own platforms, making Netflix largely dependent on third-party content for their service, whilst losing access to high-quality, marketable content

2.Netflix don't own IP rights to content (unless fully funded and produced in-house)

3.Subscription price for Netflix is rising, and is de-stabilising the affordability Netflix was known for, also making their price less competitive

4.Recommendation system is perceived to be flawed and inaccurate

5.DVD rental service only available in domestic market (US) and is a declining industry/segment for Netflix

6.Online streaming service only available with internet connection (not all markets have equal access to service/content depending on IT infrastructure)

7.Lack conglomerate financial stability of their diversified competitors

8.Fall behind in sustainability initiative compared to other tech firms

Opportunities

1.Alternative revenue streams from diversified product/membership offerings (e.g. skinny bundles with more personalisable content options)

2.Expansion to emerging markets (India and China in particular)

3.Complementary technology development (higher quality video, faster streaming, more devices etc.)

4.International partnerships (strategic alliances to provide more tailored, country-specific content)

5.Can consider to license their original content (w/ 100% ownership stake) to other platforms as a secondary source of cash flow

6.Can use marketing value stemming from "Netflix Originals" to incentivise creative projects and content creators to work in partnership with Netflix

Threats

1.Strong competitive pressures from conglomerate film studios (BBC, CBS, Viacom, HBO etc.)

2.Emerging direct competition in the media content market
Apple, Disney+, Facebook

3.Existing platforms are growing and developing competitive competencies to seize market share
Amazon Prime Video, YouTube, ESPN+

4.Other Video on Demand (VOD) revenue models can generate revenue through Pay-per-view (PPV) or Transactional VOD (TVOD) and Advertisement-supported VOD (AVOD); 30% YoY growth for VOD ads suggests trend for future business models (Muvi, 2018)

5.Piracy of content is a continuous concern for any entertainment firm, resulting in indirect losses in revenue and inaccurate representation of viewership statistics (Opam, 2017; Pelts, 2016)

6.Foreign exchange rate fluctuations are a significant variable for any operation ranging over 190 countries

Figure 6. SWOT Analysis

Accounting Analysis

Accounting Policies and Relevant Limitations

Accounting policies	***Netflix***	***Viacom***	***Impact on analysis***
Streaming content	Netflix provides a wide array of content including titles to which they have the licence to and "Netflix Originals". The fee of the titles acquired are capitalized and corresponded by a liability when the license period begins, which is when the content will be available for streaming. Amortization occurs on an accelerated basis as the company typically expects more viewing to occur at the initial period the title is published. Amortization continues an ongoing basis and much of it is down to management's judgement and estimation.	Viacom capitalizes the cost of content to then amortize the original cost based on an individual film forecast computation method. For feature films revenue forecast computation is based on the expected revenue the title will bring in 10 years from its release, while for acquired titles the time span use for computation is 20 years.	Amortization by Netflix and its peers is largely based on expectations and management assumptions, leading to discrepancies in forecasts and achieved results.
Revenue recognition	Revenues are recognised over each monthly membership period. Revenues are presented net of the axes that are collected from members and remitted to Governmental authorities. Deferred revenues consist in gift or prepaid memberships not yet redeemed.	Viacom enters an arrangement with the customer under which they perform multiple revenue generating activities. These activities consist in raising capital from advertising time of commercial units and secondly from subscriptions paid for video-on-demand and OTT services.	Revenue recognition policies therefore show two key impacts on the analysis we will conduct. The introduction of new rulings by the FASB indicates we may see differences in revenue reporting pre-and post-adoption in 2017. Secondly, Netflix does not receive revenue from advertising activities, meaning inflows are limited to subscription proceeds.
Foreign currency	The functional currency for Netflix subsidiaries is determined on the primary economic environment in which the subsidiary operates. The Company translates the assets and liabilities of its non-U.S. dollar functional currency subsidiaries into U.S. dollars using exchange rates in effect at the end of each period. Revenues and expenses for these subsidiaries are translated using rates that approximate the ones in effect during the period. Gains and losses from these conversions are recognized in cumulative conversion adjustment included in "Accumulated other comprehensive loss" on Balance Sheets. *(See Note 2)*	Liabilities and assets of subsidiaries with currencies other than the Dollar are translated into Dollars using period-end exchange rates, while results of operations are converted using rates throughout the period. Foreign currency translation gains and losses are included as a component of "Accumulated other comprehensive loss".	The procedures Netflix and its peers take into recording and converting foreign currencies will impact the information presented to the investor, therefore affecting the ratios.

**All Information taken from Netflix and Viacom Annual Reports Year(s) 2014-2017*

	Potential accounting problems	*Impact on ratio analysis*	*Impact on Credit analysis*
Amortization	The content is amortized based on assumptions and expectations. Due to the dynamicity of the sector there is a high degree of uncertainty in the accounting for this. Discrepancies in amortization periods leads to Netflix missing earnings targets or negatively impacting reported results.	Revising and reducing current amortization periods will result in impairment charges for the relevant content assets resulting in greater in-period expenses. This will affect the way Netflix accounts for its liabilities.	Divergences in forecasts lead to a fall of the value of traded stock. This will affect its profitability assessment.
Costs of Revenue	Netflix accounts expenses associated with acquisition, licensing, production of content, streaming delivery costs and operational costs such as amortization under *costs of revenues*. Lack of distinction of these costs lead to an increase in the figure with no clarity.	Growing *cost of revenues* leads to cash flow issues, negatively affecting liquidity ratios.	Netflix's accounting of costs associated to product diversification has negative effects on already negative cash flows. This leads to it becoming increasingly leveraged, impacting their credit and revenue assessment.
Foreign currency conversions	Netflix converts assets and liabilities of its non-U.S. dollar functional currency subsidiaries into dollars using exchange rates in effect at the end of each period. Problems may arise as policy does not use exchange rate effective when asset was bought or liability incurred. This could mean the conversion does not reflect the true value of the transaction.	May lead to inaccurate information for liquidity and return ratios.	With a cumulative translation adjustment of $21.8 million in other comprehensive loss at the end of December 2015, creditors may overvalue industry risk due to its geographic diversification.
Revenue	Netflix's only revenue stream is through the monthly subscriptions paid by its customers.	The revenue is lower than the cost it incurs. It struggled to produce enough revenue to fund its upcoming projects as they aim on increasing the number of "Originals". This leads to cash flow problems and high leverage.	The single revenue stream makes Netflix hard to compare to its peers as they mostly engage in more than one revenue-producing arrangement, affecting its revenue assessment.

Figure 7. Accounting Policies

- Netflix's industry is mainly based on the amount and quality of the content on the site. Therefore, a key point addressed in the accounting policies regards the treatment of the *streaming content.*
- Secondly, the market operates predominantly on inflows based on subscriptions, therefore we look at the way revenue is recognised by Netflix and its peers, looking at their *revenue recognition* policies (See Note 1).[1]
- Thirdly, the analysis looks at how Netflix treats *foreign currencies.* Global expansion of Netflix has meant a significant portion of their accounting policies is concerned with the treatment and recognition of foreign currencies (See Note 2)[2].

[1] *Note 1: In May 2014, the FASB issued ASU 2014-09 which included the "Revenue from Contracts with Customers" which implied adoption from reporting periods starting December 2015. As early adoption is not permitted, it may be applied retrospectively to previous reports, but must be considered when looking at reports post 2016. Revenue is recognised to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This information can be seen in the annual reports from 2014 when change was passed and reports from 2017 where it was implemented in the financials for the first time.*

[2] *Note 2: Prior to January 2015, the functional currency of European subsidiaries was the British pound, following the transfer of European headquarters and the expansion of the Netflix in several European countries it was then changed to the Euro.*

Ratio Analysis

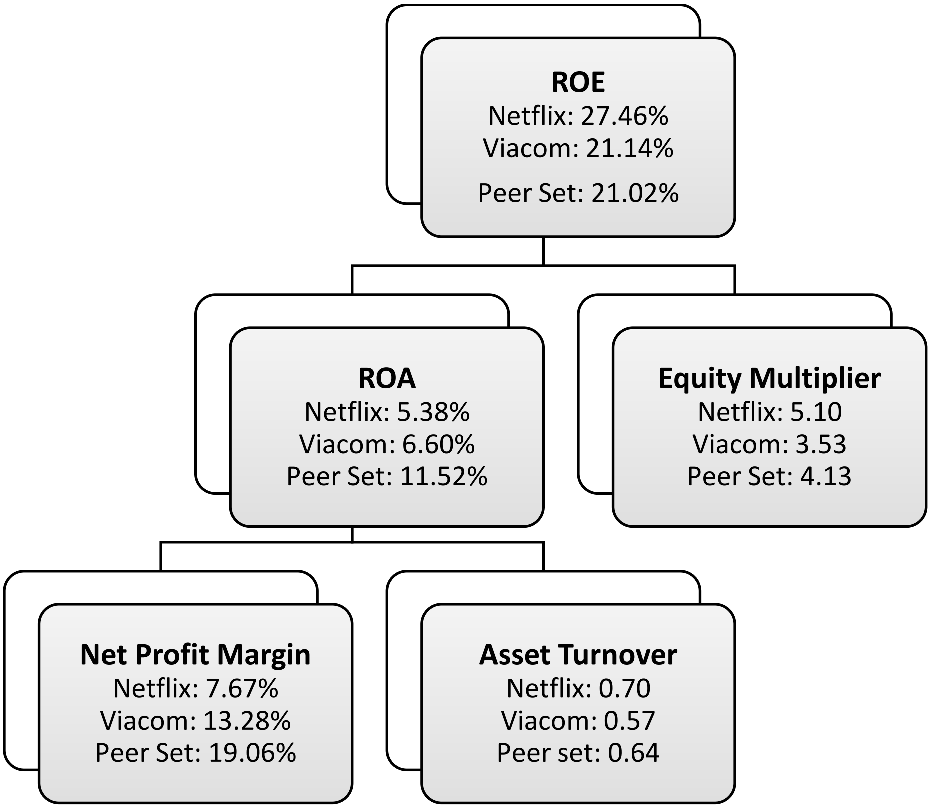


Figure 8. ROE Decomposition

- Netflix's ROE appears above the peer set average. Netflix shows a superior operating performance compared to that of its competitor, up by 6%. The platform's ROA is lower than Viacom's and the peer set. The main driver is its significantly lower profit margin, diminishing the impact of its high asset turnover. Netflix's superior ROE compared to Viacom is due to its high equity multiplier. Signifying that Netflix uses more leverage compared to its competitor, and its peer set, to generate their ROE. This is due to the company's focus on debt financing to gather funds for investment in original content, in the hopes of yielding larger returns in the future.

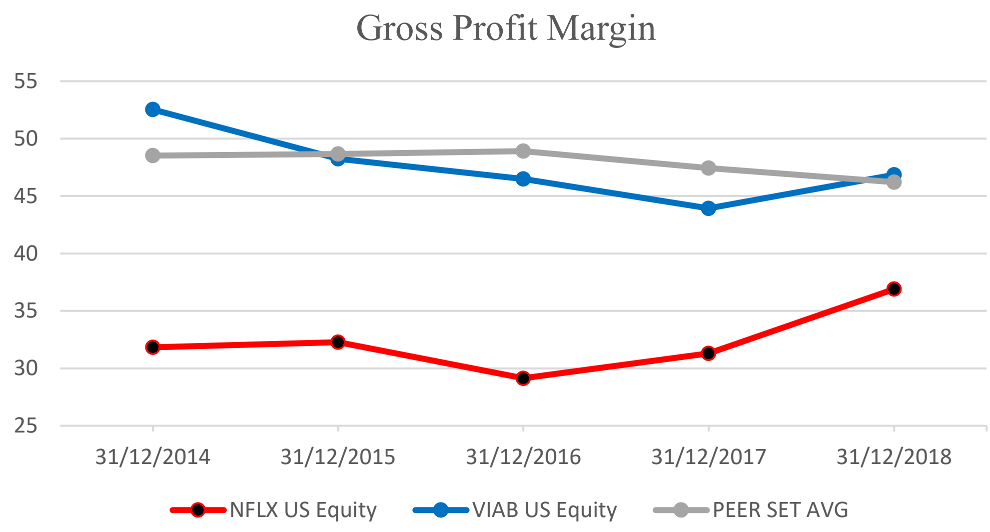


Figure 9. Gross Profit Margin

- Figure 9 displays a significantly lower gross profit margin compared to Viacom & the peer set which remain close to one another.
- Netflix's low gross profit is due to their continuous increase in operating expenses (Fig. 11) and costs of revenue between 2014-2018. Amortization of content makes up the majority of their cost of revenues and their focus on expanding their content library by acquiring explains their below average gross profit performance.

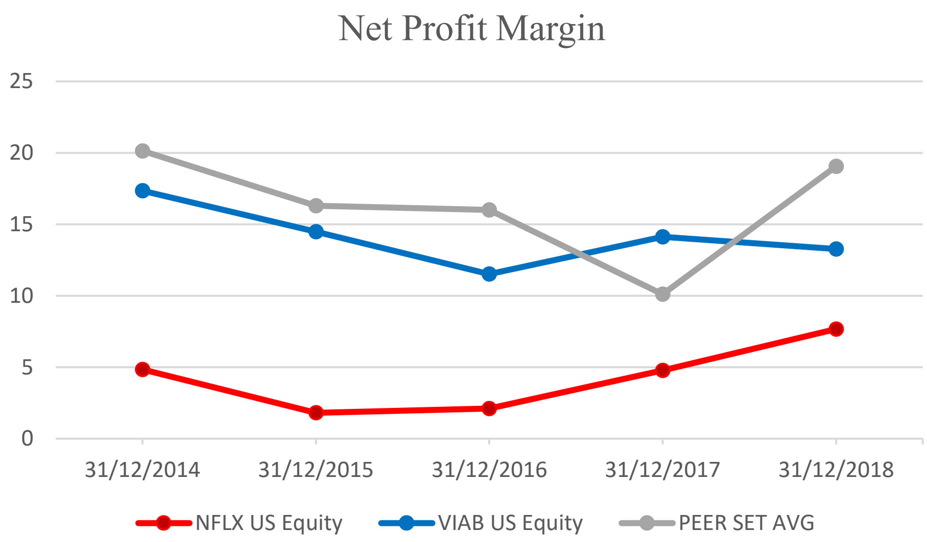


Figure 10. Net Profit Margin

- The net profit margin figure is used to compliment Fig. 9 showing that their below average profitability is mainly driven by the high costs of revenue in the gross profit. The gap between Netflix and the peer set is similar in both figures, showing that interest and tax do not have a major factor in their operating performance.
- It is important to acknowledge the increasing trend for both net and gross profit margin, since 2016, signifying that despite high commitment on expanding the business, their profitability appears promising.

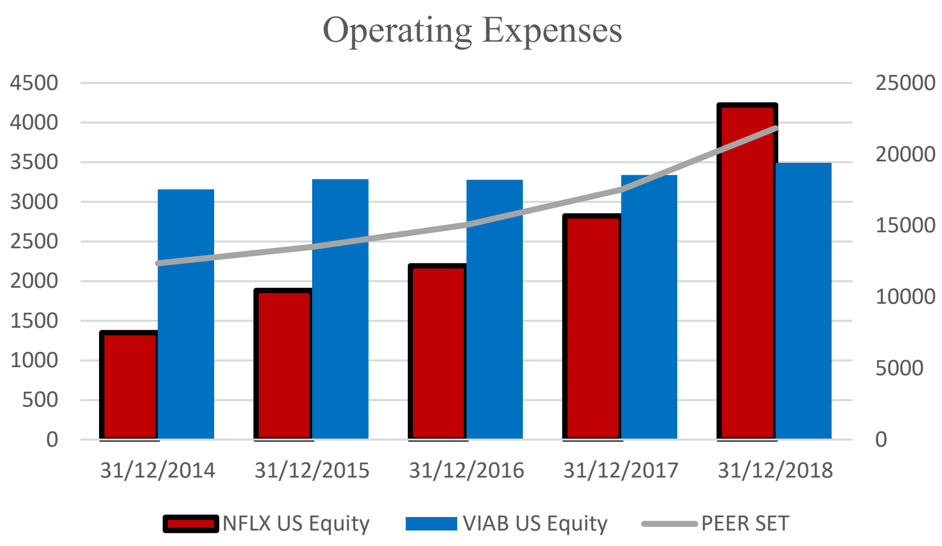


Figure 11. Operating expenses

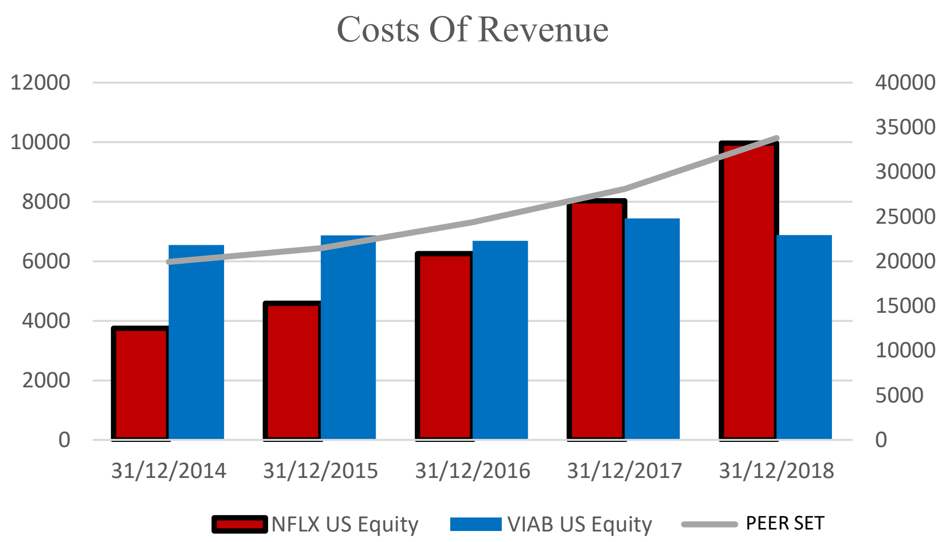
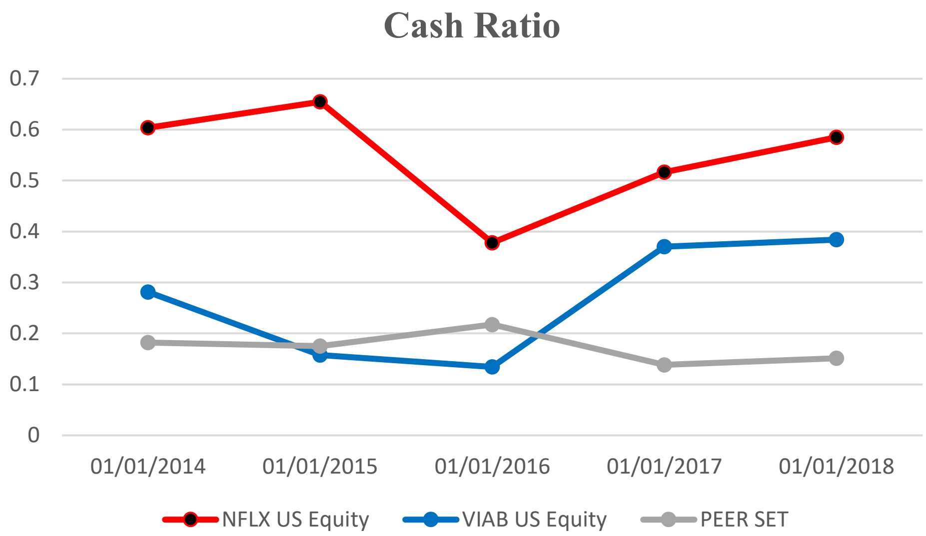


Figure 12. Cost of Revenue

- Netflix's operating expenses trend follows that of the peer set overtime. The peer set line was plotted on a secondary axis to factor out the size of the companies.
- Net income is increasing parallel with their expenses, showing a positive relationship between new content expenditure and profitability.
- The 67% increase in expenses from 2017-2018 is due to increasing competition. Domestic customer acquisition costs for Netflix rose by 48% in 2018 compared to 2017, as Disney and Viacom announced the launch of their own Video-on-Demand (VOD) platform. This meant a further need to license and produce more content to acquire & retain customers.
- Because of their accounting policy of amortizing content on an accelerated basis, the introduction of new content in response to competition were reflected immediately in the income statement. Whereas Viacom's expenses were kept stable throughout the 5-year period as their content is accounted for on a 10-or20-year revenue forecast computation basis.



[3]

Figure 13. Cash Ratio

- ❖ The media industry is highly leveraged due to the high costs associated with production, licensing and global distribution of content, explaining why all data points are below the general benchmark value of 1.00.
- ❖ Netflix's liquidity appears to be significantly above its competitor and its peer set.
- ❖ The dip from 0.65 to 0.38 between 2015-2016 is explained by their global expansion at the start of 2016, becoming available in all but 3 countries worldwide. Such expansion required the release of region-specific content, increasing their current liabilities.
- ❖ Viacom & Netflix depict a similar exponential increase in cash ratio post 2016, compared to the peer set
- ❖ For Netflix this can be explained by their multi-year commitments associated with the expansion of its original programs, lowering the value of their current liabilities and increasing the cash equivalents needed to finance the content's production
- ❖ Viacom's increase comes from an increase in debt required to finance their buyback of shares and business investments responding to VOD competition (acquired TV streaming service Pluto TV in 2019)

[3] *Google was excluded from the peer set for the cash ratio as it skewed the data*

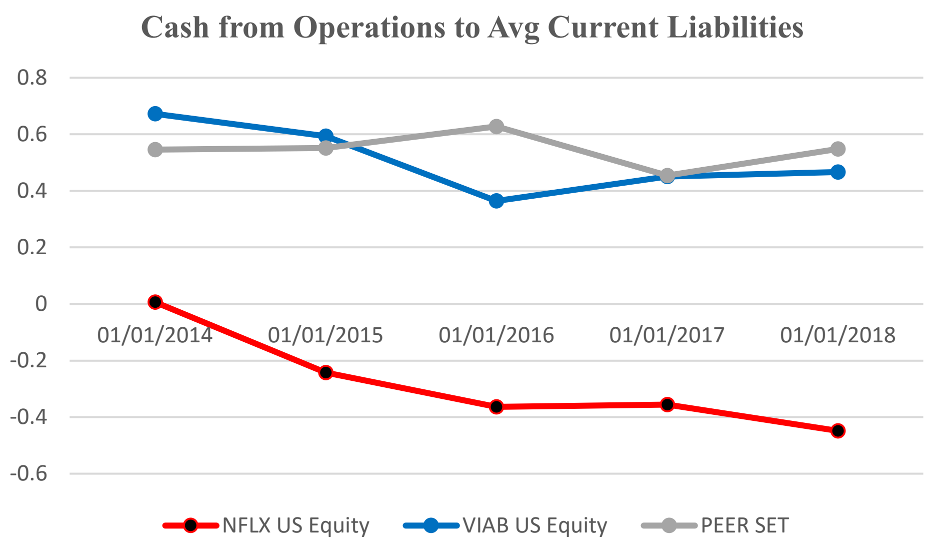


Figure 14. CFO / AVG CL

- The graph depicts a decreasing trend for Netflix over the time-series, compared to its competitor
- The negative ratio is explained by their decision to continue increasing the production of original content disproportionally to their cash from operations
- Compared to Fig. 13, it can be concluded that Netflix's above average cash ratio is laregely due to additional capital (debt or equity) requested by the company to finance their investments

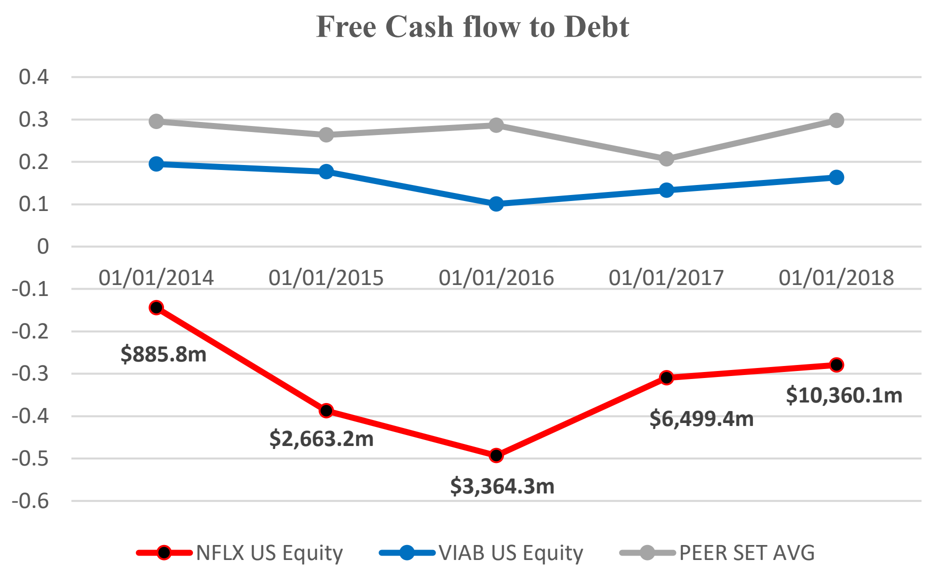


Figure 15. FCF / Debt

- Netflix's negative debt coverage ratio stems from the company's continuous increase in debt over the last 5 years (as shown by the data labels)
- All of the company's debt comes from long-term obligations which are used to finance the production of original content

- Since 2016 there is an increase in debt and a positive correlation between the value of debt takings and the coverage ratio, showing that debt borrowings are utilized efficiently to improve Netflix's current and future performance.

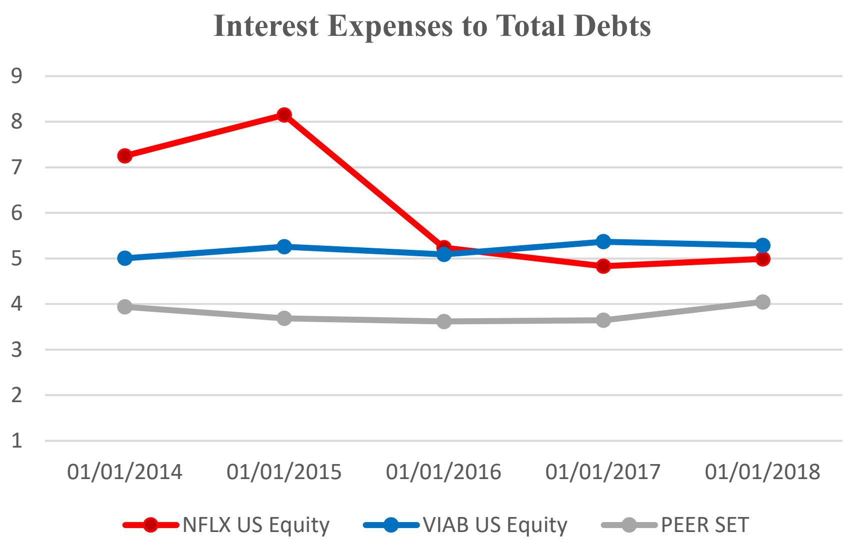


Figure 16. IntEx / Total Debt

- Despite a net decline in interest-to-debt, Netflix still has a higher figure compared to its peer set, indicating potential for financial distress.
- The rapid decline from 2015 to 2016 is due to the incremental increase in interest expenses compared to the disproportionate debt takings (Fig. 16).

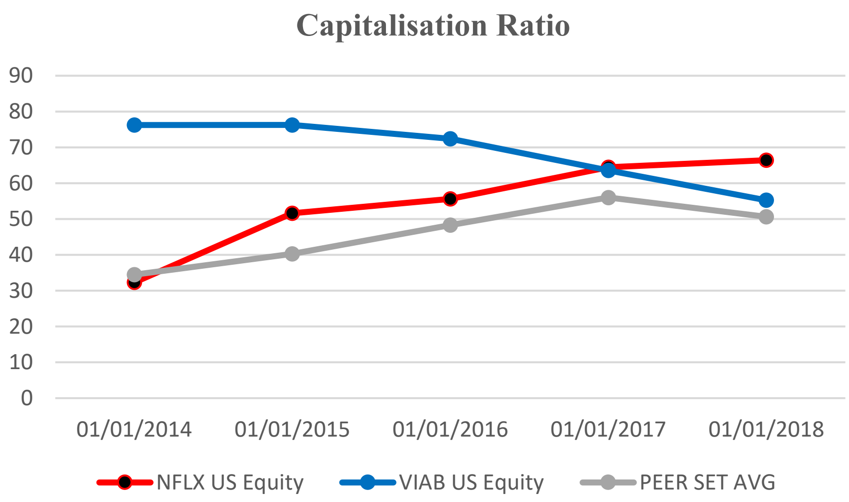


Figure 17. Capitalisation Ratio

- Netflix's capital structure appears to be significantly better than Viacom's, explaining Netflix's superior ROE despite their low ROA due to their on increasing the asset base.
- Viacom's initial abnormal pattern is explained by their share buyback decision between 2012-2015 requiring $10.4 billion in cash to regain control; the buyback appears successful as more equity is employed to purchase assets, shown by the decrease of the ratio post 2016
- Netflix has overall outperformed their competitor at converting debt to assets yet remained more leveraged than the peer set overtime.

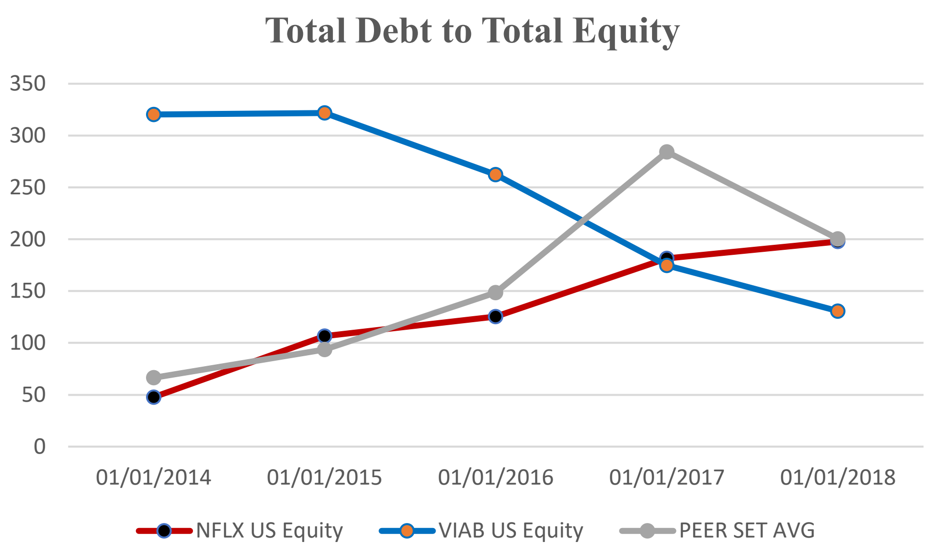


Figure 18. TD / TE

- The platform is justifying their highly leveraged position with the growing subscriber count (Fig. 19), and is recurrently referring to the stock market
- Netflix has continuously referred to the bond market, with the latest issuing of an additional $2bn in junk-bonds in Q4, 2018 (FT 2018) for a fourth time that year, justifying their increasing total-debt-to-equity ratio

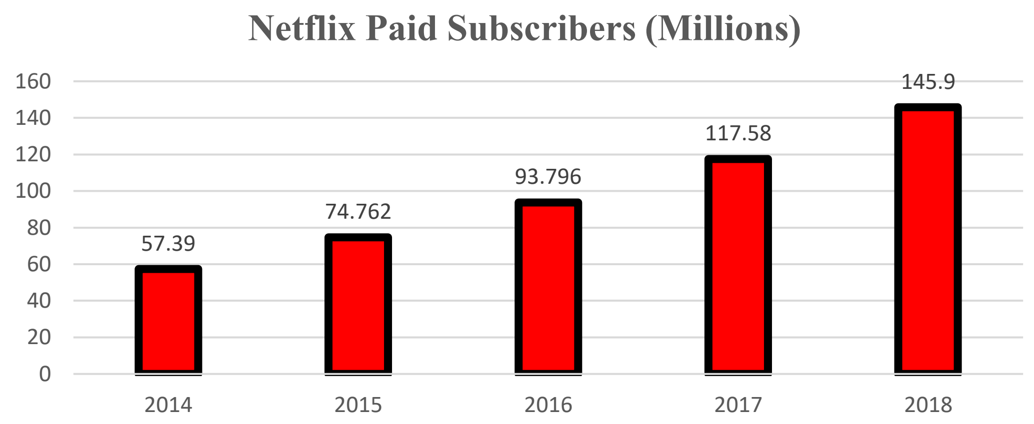


Figure 19. Netflix Subscriber by Year

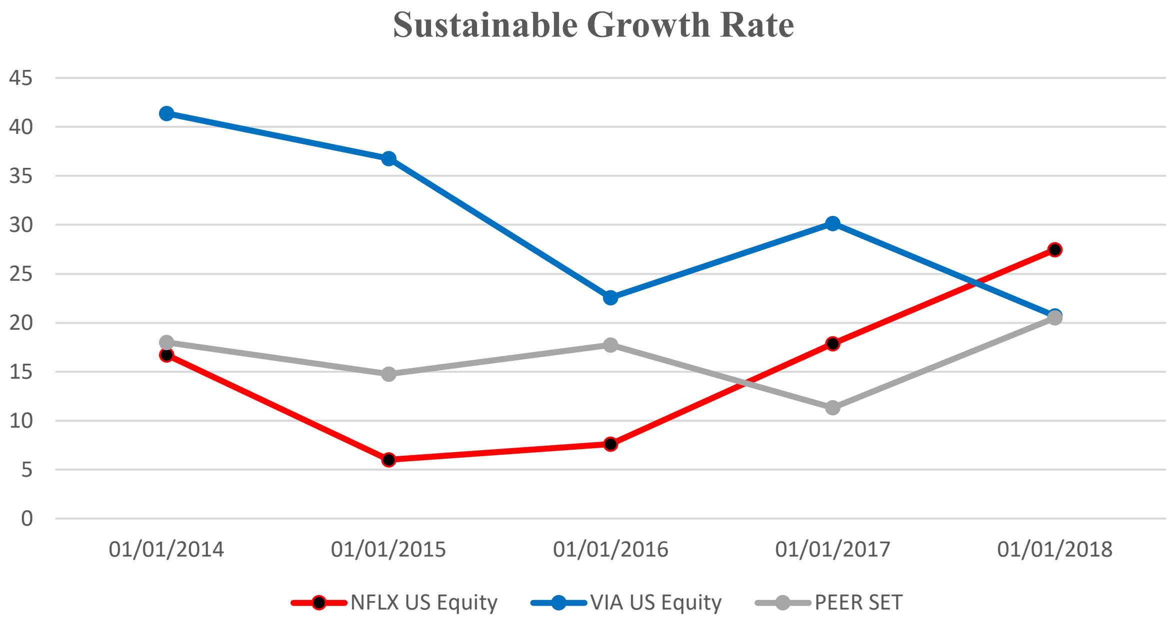


Figure 20. Sustainable Growth Rate

- ❖ The growth pattern of Netflix appears almost identical with the trend shown in their profitability ratios and that of free-cash-to-debt (Fig. 15), supporting the rather positive comments on the recent financial situation
- ❖ The platform's global expansion in 2016 proves to be a turnaround to the company's performance, triggering a 10% year-on-year increase in the subsequent years
- ❖ Netflix's disruptive business model is seen as a threat to Viacom, indicated by the negative and fluctuating growth rate overtime and their attempts to enter the VOD market
- ❖ Netflix scores above the peer set in FY17-18 (+6.7% on average)
- ❖ In FY 2019, competition is set to disturb this forecast with Disney and Apple entering the VOD segment, the former leveraging on their original content assets and the latter on its superior liquidity.

Cashflow Analysis

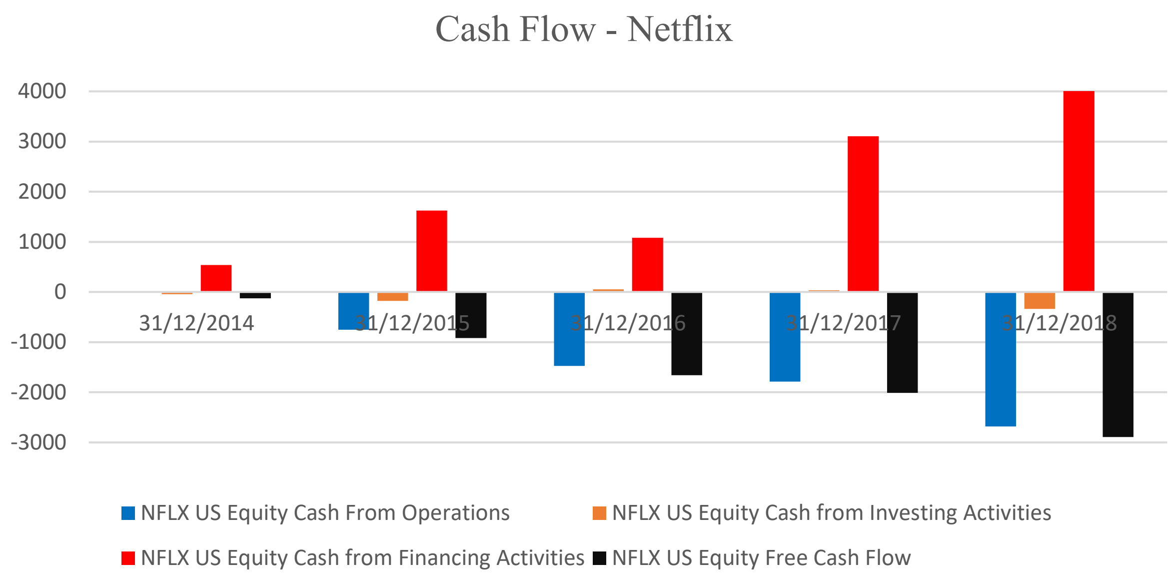


Figure 21. Cash Flow Segmentation by FY

Netflix's CFO remains negative throughout the years due to high investment in new streaming content requiring up-front payment. These productions are costly and increase the Cost of Revenues, which explains the low inflows from operations which contribute to the negative free cash flows of Netflix. Cash from investing activities decreased by $15.4 million in 2018 due to an increase of $65.6 million in purchases of property and equipment for the California headquarters in Los Gatos. As aforementioned, Netflix is a heavily debt leveraged company, as we see from the consistent and high cash flows from Financing activities.

Credit Analysis & Debt Rating

Industry Risk
Operating in multiple industries, Bloomberg considers Netflix a part of the internet media and entertainment content sector while it is also known as a pioneer in the OTT market. Netflix now faces the threat of substitutes such as Amazon Prime, which counts 26 million US users. Companies in the entertainment sector are also moving towards OTT, such as Viacom with the acquisition of PlutoTV and Walt Disney with the Hulu joint venture and their own Disney+. The market focus towards the industry is explained by its exponential growth; OTT market is set to grow at a CAGR of 17% from 2018 to 2022 (Business Wire, 2018).

Netflix's business model represents its primary industry risk. Their subscription structure allowed rapid growth and successful market capitalisation. Nevertheless, the barriers for entry in the market are low, allowing large and financially stable businesses such as Amazon and Walt Disney to enter through new or joint ventures. Streaming content is where companies can gain competitive advantage. Netflix's strategy has been producing "Netflix Originals" content. Netflix remains a company based on intangible assets, meaning it is heavily debt leveraged. Netflix increasing spending on content to remain competitive leads to increased Costs of Revenue, worsening their free cash flow standing. In conclusion, Netflix's risk is down to the fact they operate in an industry where competitors are not comparable, as their OTT operations represent a relatively small percentage of their core activities.

Product and Geographic Diversification

The content provided is key to gaining competitive advantage in this market. Companies like Viacom, Amazon and Netflix respond to the challenge of costly rights acquisitions by producing original content. In this case, we see Netflix take a dominant position, due to the amount and quality of their Originals. The success of series like "Stranger Things" meant Netflix managed to diversify their offering to the rest of the industry.

Regarding geographic risk, Netflix points towards eliminating this by engaging into aggressive global expansion. The geographic growth of the company is one of the core sources of its success. Netflix segments geographic data in their statements as "domestic" and "international". We see in Q4 of the 2018 Income Statement, the International revenue exceeded Domestic revenue by 0.6%; a considerable landmark for a company with only US operations prior 2010.

	Risks
International	• Risks due to fluctuations of foreign currency exchanges • Governmental bans limit expansion to countries e.g. China, and limits the content they can show • High speed internet is not available in certain territories, limiting reach • Lack of competitors in areas such as Brazil, made growth slow as population is sceptical of business model • Global expansion leads to higher costs, making it hard to keep subscription costs equal globally • Global reach has come with controversy over politically oriented content such as "The Mechansism", "Fauda" and "Amo".
Domestic	• While overseas may have little competition, the saturate US market is increasing customer acquisition costs exponentially • The presence of streaming platforms such as Hulu, owned by Viacom, is a threat as their subscription plans get cheaper and Netflix's gets more expensive • Netflix cannot compete with competitors such as Amazon as they are exponentially strong financially • Alphabet's YouTube competes with Netflix over the attention of American consumers, with majority of the population watching YouTube. However, Netflix is still considered higher quality content.

Figure 22. Geographic Risk

Revenue Assessment

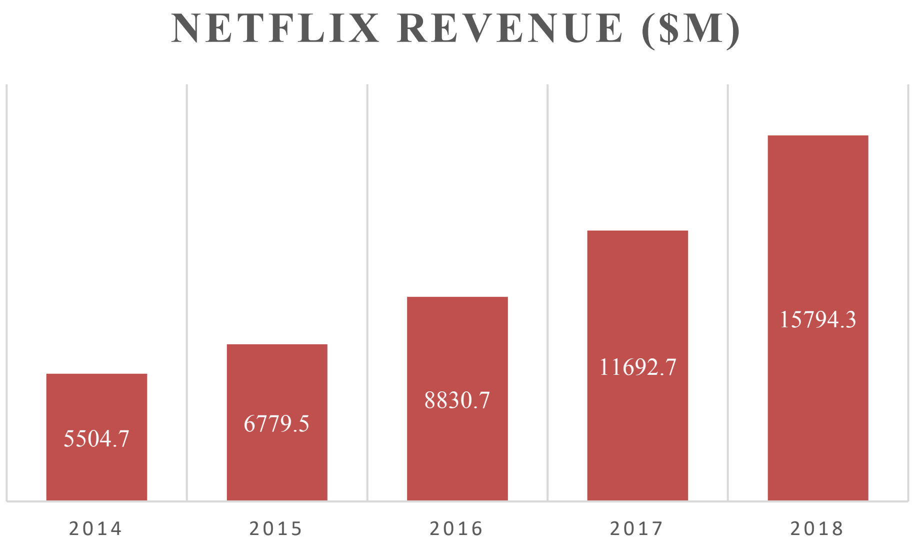


Figure 23. Netflix Revenue

❖ Positive revenue growth figures for Netflix reflect their success in the international streaming segment since their global expansion in 2016.

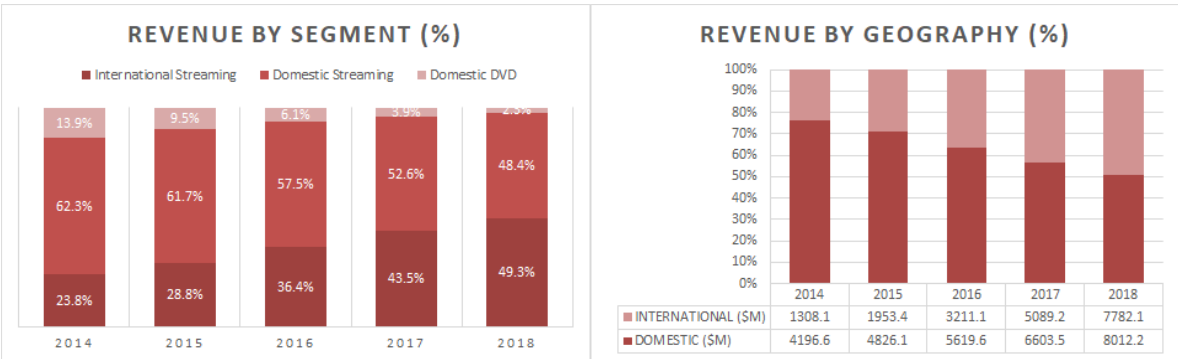


Figure 24. Revenue (%) by Product & Geography Segment

❖ Revenues are increasingly reliant on by the international segment as the domestic market becomes saturated and competitive, and their DVD segment suffers from YoY decreases in revenue due to shift in consumer preferences. Due to their recent expansion to 130 international markets (2016), Netflix holds potential for organic growth in memberships (i.e revenue) through their current global strategy.

Profitability and Cash Efficiency Assessment

Profitability Ratios	Netflix	Viacom	Peer Average
Gross Profit Margin	36.89%	46.85%	37.10%
EBITDA Margin	10.69%	21.50%	19.59%
Operating Profit Margin	10.16%	19.86%	20.77%
Pre-Tax Profit Margin	7.77%	15.43%	20.38%
Net Profit Margin	7.67%	13.28%	17.61%
Return on Equity	27.46%	25.58%	38.53%
Return on Assets	5.38%	7.24%	10.92%

Figure 25. Profitability Ratios

- ❖ Their profits are positive even though their margins are still below average. This indicates the strong amortization Netflix undergoes on its statements for their streaming content.

Liquidity & Coverage

COVERAGE RATIOS	Netflix	Viacom	Peerset AVG
Total Debt/EBITDA	6.14	3.62	1.556666667
Net Debt/EBITDA	3.89	3.06	0.711
EBITDA to Interest Expense	4.02	5.37	128.97[4]
FCF To Interest Expense	-6.88	2.94	71.72[5]

Figure 26. Coverage Ratios

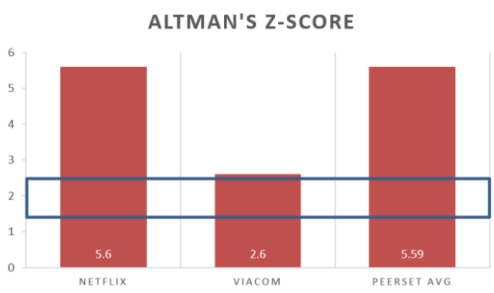


Figure 27. Z-Score

LIQUIDITY RATIOS	NETFLIX	VIACOM	PEERSET AVG
Cash Ratio	0.5849	0.3841	1.151766667
Current Ratio	1.4943	1.4988	2.1125
CFO/Avg Current Liab	-0.4485	0.4668	0.909566667
CFO/Total Liabilities	-12.9269	11.3365	42.155
Total Debt/Equity	197.7576	130.7483	134.3409667
Total Debt/Capital	66.4156	56.6627	36.15783333
Total Debt/Total Assets	39.8856	42.3916	23.1165
Total Line of Credit	500	2500	6250

Figure 28. Liquidity Ratios

- ❖ Netflix's use of debt financing affects their ability to cover immediate expenses associated to contractual obligations and interest expenses in comparison to the peerset; their liquidity figures suggest that their CFO is insufficient for covering liabilities, and even though there is revolving credit available, their content acquisition strategy relies on future returns from current investments. This strategy has proven to be successful throughout their expansion, implying stable corporate operations, in line with the strong Z-scores of technology firms; however, as more competitors enter the market, the likelihood they can sustain positive margins in relation to accrued debt diminishes.

[4] Offset by Alphabet (ND/EBITDA = 354)
[5] Offset by Alphabet (FCF/IntExp = 201)

Capital Structure

❖ Netflix's capital structure has increasingly transitioned from equity to debt financing (Figure 29) to leverage the costs of their international streaming segment and its rampant financial obligations associated to Original content production and acquisition to remain competitive in the OTT industry (Figure 30). The Company aims to reach an optimal structure once their debt-to-market capitalisation ranges between 20-25%; thus debt in excess of $20B must be issued to reach this ratio, and to purposefully increase leverage as a corporate strategy.

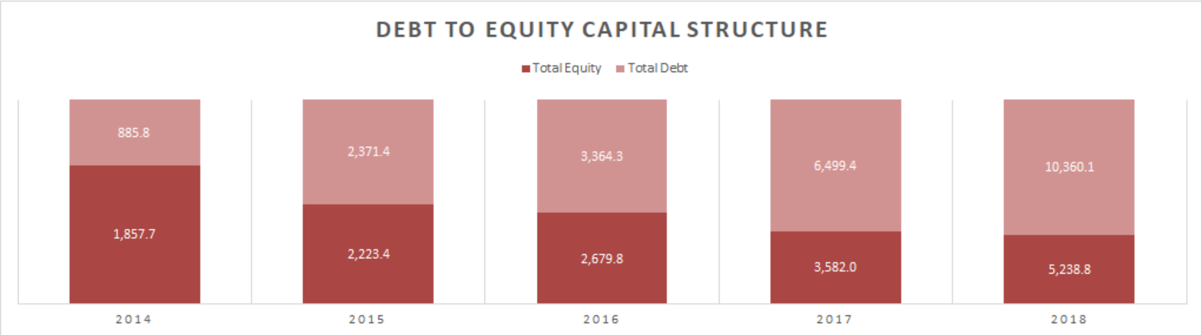


Figure 29. TD/TE

❖ Though Netflix's (FY18) $116,859.98B market capitalisation and $267 share price reflect positive market outlooks for their operations, (despite their consistent YoY negative FCF), the Company turns to the junk-bond market, offering fixed-return unsecured senior notes to raise capital for their operations.

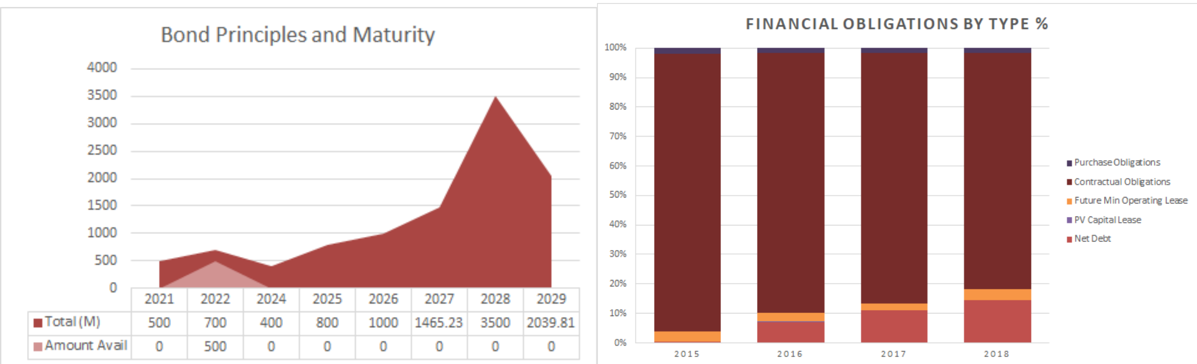


Figure 30. Netflix Bond Maturities and Financial Obligations

❖ The result is higher financial obligations associated to bond repayments, with varying lengths, and coupon rates; thus, Netflix's LT solvency becomes a concern as they resort to debt rather than equity to finance their future operations, whilst exhibiting YoY negative FCF. However, bondholders are investing in the LT, much like Netflix is, suggesting that investors have a positive outlook regarding this decision and that returns are expected.

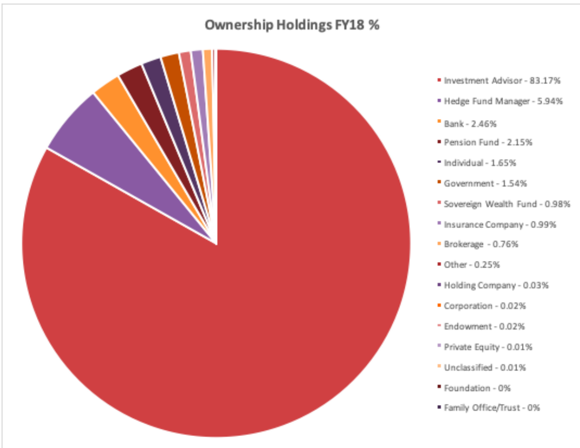


Figure 31. Equity Holdings

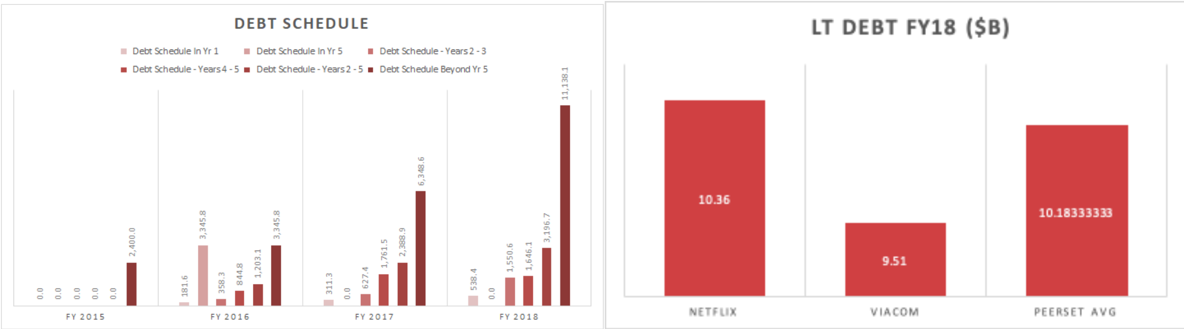


Figure 32. Netflix Debt Obligations Schedule and Total LT Debt

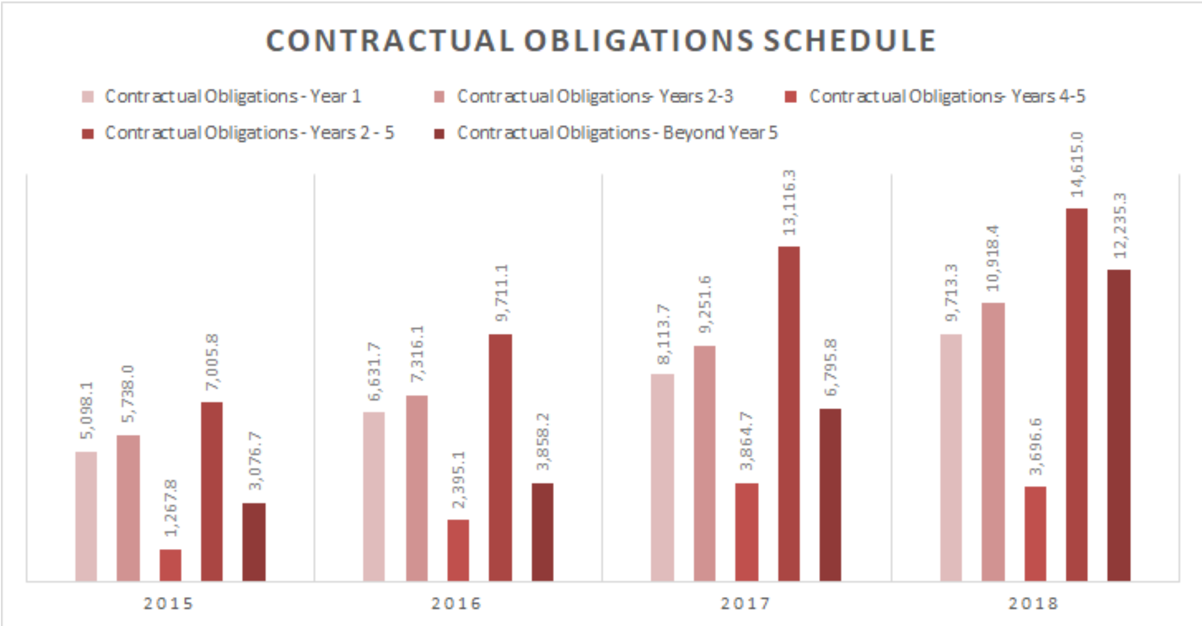


Figure 33. Contractual Obligations by maturity

Credit Rating Assignation

Netflix Rating Factors	Weightings	Aaa	Aa	A	Baa	Ba	B	Caa
Factor 1: Industry Risk	**10%**							
Video Entertainment Industry Outlook	10%		•					
Factor 2: Product and Geographic Diversification	**25%**							
Qualitative Assessment of Portfolio Positioning	10%		•					
Geographic exposure	8%		•					
Geographic risk	7%				•			
Factor 3: Revenue Assessment	**10%**							
Total Net Revenue 2018	5%			$15,794				
Earning Volatility	3%				•			
Revenue by segment (Domestic/International)	2%				•			
Factor 4: Liquidity and Coverage	**20%**							
Total Debt/EBITDA	2%						6.14	
Net Debt/EBITDA	1%					3.89		
EBITDA to Interst Expense	1%					4.02		
FCF To Interest Expense	1%						-6.88	
Cash ratio	2%					0.58		
Current Ratio	1%				1.4943			
CFO/Avg Current Liabilities	1%						-0.44	
CFO/Total Liabilities	2%						-12.92	
Total Debt/Equity	2%						197.75	
Total Debt/Capital	2%					66.41		
Total Debt/Total Assets	2%					39.88		
Total Line of Credit	1%						500	
Altman's z score	2%				**5.6**			
Factor 5: Profitability and Cash Efficiency Assessment	**25%**							
Gross Profit Margin	4%				36.89%			
EBITDA Margin	5%						10.69%	
Operating Profit Margin	3%						10.16%	
Pre-tax Profit Margin	5%						7.77%	
Net Profit Margin	3%						7.67%	
Return on Equity	2%					27.46%		
Return on Assets	3%					5.38%		
Factor 6: Capital Structure	**10%**							
Debt to Equity Capital Structure	5%					•		
Ownership Holdings	1%					•		
Debt Schedule	2%				•			
Contractual Obligations Schedule	2%				•			
Rating:								
Indicated Rating from Methodology	Ba							
Actual Rating Assigned	Baa							

Figure 34. Credit Rating

Forecasting

Macroeconomic factors:

As a digital media provider, a driver for Netflix's future growth will be the rise in global internet connectivity. Between 2015-2019 the number of internet users worldwide increased from 43% to 56.1%, with developing regions showing rapid improvements. Low-cost telecom provider, Reliance Jio has invested over $37B in scaling 4G connectivity in India. Acquiring over 280m subscribers and a 26% market share (The Economist 2019) since its launch in 2016. Jio's performance is an example of the efforts in Asia-Pacific to improve internet connectivity, making the economic climate favourable for online businesses such as Netflix. Netflix's global presence and their pricing strategy consisting of boosting prices in developed regions and lowering them in emerging markets, e.g. Asia, is set to yield positive results. The platform's focus on glocalization – releasing content specific to local preferences to add to their already highly reputable library – is the key basis of the assumption of projected sales growth.

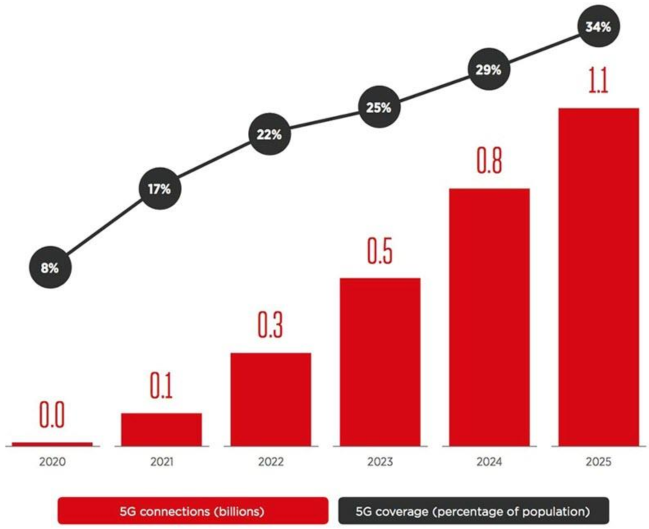


Figure 35. Expansion of 5G Network

Furthermore, the expected diffusion of 5G technology in the upcoming decade proves promising for Netflix's future. 5G will allow faster video streaming of superior quality, compared to today, indicating a further potential increase in users and ability to expand into innovative content production (VR).

Projections - Base Case							
			Calendar Year Ending 31st December, $m				
			2019	**2020**	**2021**	**2022**	**2023**
Sales	*%YoY*	*25.99%*	19970	25248	31923	40361	51031
Cost of Sales	*%Sales*	*65.99%*	13177	16661	21065	26633	33674
Gross Profit			**6792**	**8588**	**10858**	**13728**	**17357**
Operating Expenses	*%Sales*	*25.60%*	5112	6464	8172	10332	13064
Operating Profit			**1680**	**2124**	**2686**	**3396**	**4293**
Interest	*%Sales*	*2.10%*	419	530	670	848	1072
Profit before Tax			**1261**	**1594**	**2015**	**2548**	**3222**
Tax		*0.10%*	1.3	1.6	2.0	2.5	3.2
Net Income			**1259**	**1592**	**2013**	**2545**	**3218**

The first case is based on a five-year weighted moving average. The latest revenue figure was taken and divided by the average to project the future year-on-year growth, as the average depicted a decreasing trend which we felt was not representative of the forecast. The derived CAGR% was 26%, slightly less than the company's historical revenue growth rate of 29.15% (2014-2017). The weighted average was split in the following way:

- 2015 = 5%
- 2015 = 5%
- 2016 = 10%
- 2017 = 40%
- 2018 = 40%

The weighting puts particular attention on Netflix's recent performance after its global expansion in 2016, which was most relevant to its projections. Over the forecasted period the 5-year-weighted average was utilized to project Netflix's costs of sales (65.99%) and their operating expenses (25.60%). Whereas the projected interest (2.1%) and tax rate (0.1%) were calculated using a three-year moving average. The base case predicts a strong steady increase in sales, from (FY2018) 19996m to (FY2020) 31922m, as we believe the company will continue to grow exponentially based on its recent global strategy.

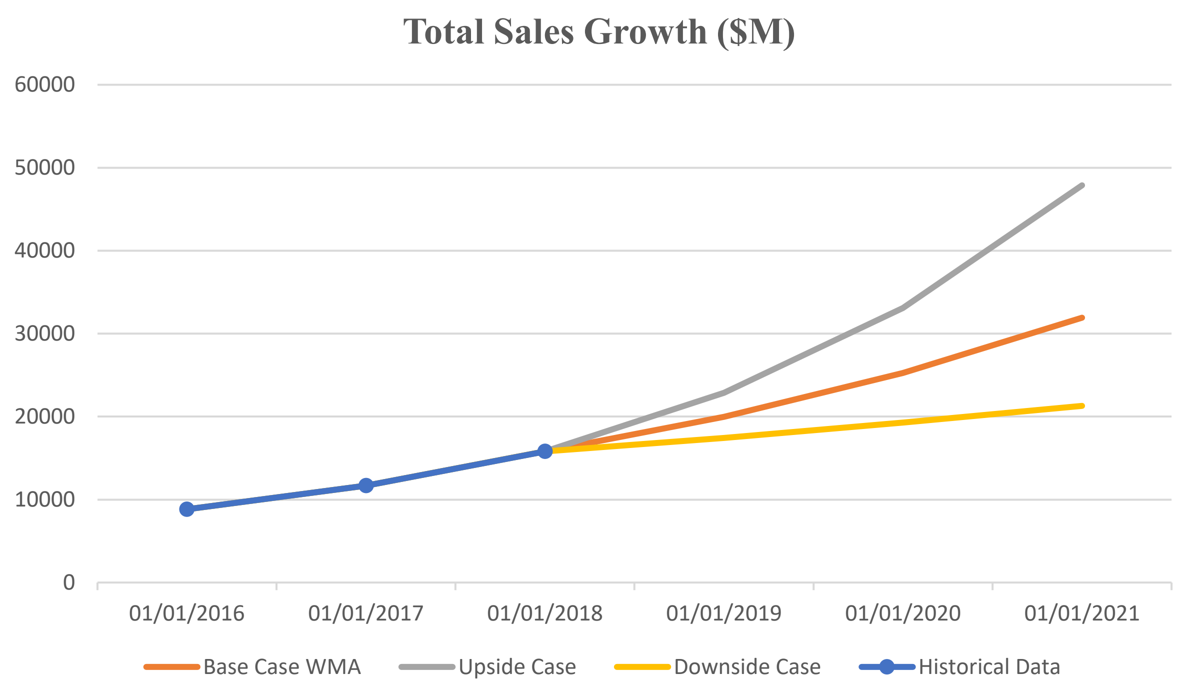


Figure 36. Netflix Forecasted Revenue

The downside case depicts a reserved outlook on Netflix's revenue growth. The projections are made using the five-year weighted moving average for sales growth and gross profit. The sales projections in this case are (FY2019) $17744m & (FY2021) $21293m. The increase in competition in the OTT segment and the heavy investments by conglomerates Amazon, Apple and Disney in their own streaming services, can impede Netflix's rapid sales growth. Netflix reported a decrease in their revenue from their domestic segment, down by 6% in 2018, due to saturation. Additionally, the termination of content licenses with Disney and other media companies could cause users to end their subscriptions. Furthermore, the "pay wall" business model in comparison to unpaid services like YouTube, can reduce the incentive for new users to join the platform.

Lastly, we present an upside scenario based on the five-year moving average for sales. Netflix's large investments in original content have had a successful reception by the public, with their most recent production Roma (2018), earning three Oscars and a star-dusted Hollywood film (budget of $190m) due to air in March 2019. The focus on high-budget productions continues to attract more users, as the platform exceeds the forecasted subscriber counts quarter by quarter. Based on that, the upside case presents a CAGR of revenue of 44% with (FY2019) $22859m and (FY2021) $48880m. We predict the net profit to slow in growth from 2018-2019, as costs of revenue and operating expenses will rise rapidly in proportion to sales. This forecast is based on Netflix's need to increase their marketing budget and content assets to acquire new users and retain their position as a market leader, as they prepare to face new entrants in the OTT industry. The projection for rapidly increasing net profit post 2019, is based on their ability to successfully convert debt into assets and the strong global brand.

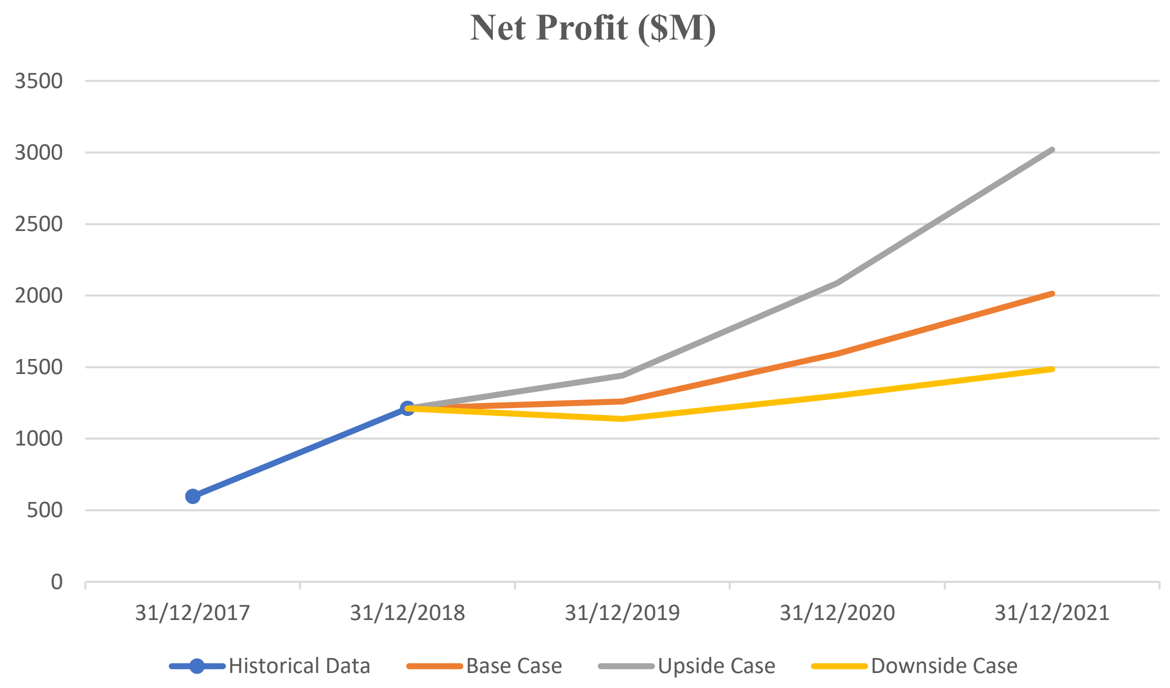


Figure 37. Netflix Forecasted Net Profit

Valuation

	Market Data				Financial Data				Valuation				
	Price	Market Cap	TEV	TTM EPS	Revenue	EBITDA	EBIT	Net Income	EV/Rev	EV/EBIT	EV/EBITDA	P/E	P/Book
	($)	($M)	($M)	($)	($M)	($M)	($M)	($M)	(x)	(x)	(x)	(x)	(x)
Netflix	267.64	116722.51	123288.09	2.68	15794.34	1688.38	1605.23	1211.24	7.81	76.80	73.02	99.86	22.31
Viacom	33.76	13738.60	22567.60	4.12	12943.00	2783.00	2570.00	1719.00	1.74	8.78	8.11	8.20	1.84
CBS	43.72	16365.30	26195.30	5.19	14514.00	2991.00	2768.00	1960.00	1.80	9.46	8.76	8.42	5.82
Alphabet	1045.86	723246.09	618118.09	42.72	136819.00	35356.00	26321.00	30736.00	4.52	23.48	17.48	24.48	4.09
Disney	116.93	173918.15	195836.15	6.95	59434.00	17815.00	14804.00	12598.00	3.30	13.23	10.99	16.81	3.60
High	1045.86	723246.09	618118.09	42.72	136819.00	35356.00	26321.00	30736.00	4.52	23.48	17.48	24.48	5.82
Average	310.06	231817.03	215679.28	14.75	55927.50	14736.25	11615.75	11753.25	2.84	13.74	11.34	14.48	3.84
Median	80.32	95141.72	111015.72	6.07	36974.00	10403.00	8786.00	7279.00	2.55	11.35	9.88	12.62	3.84
Low	33.76	13738.60	22567.60	4.12	12943.00	2783.00	2570.00	1719.00	1.74	8.78	8.11	8.20	1.84

Figure 38. Multiple Valuation w/ Peerset

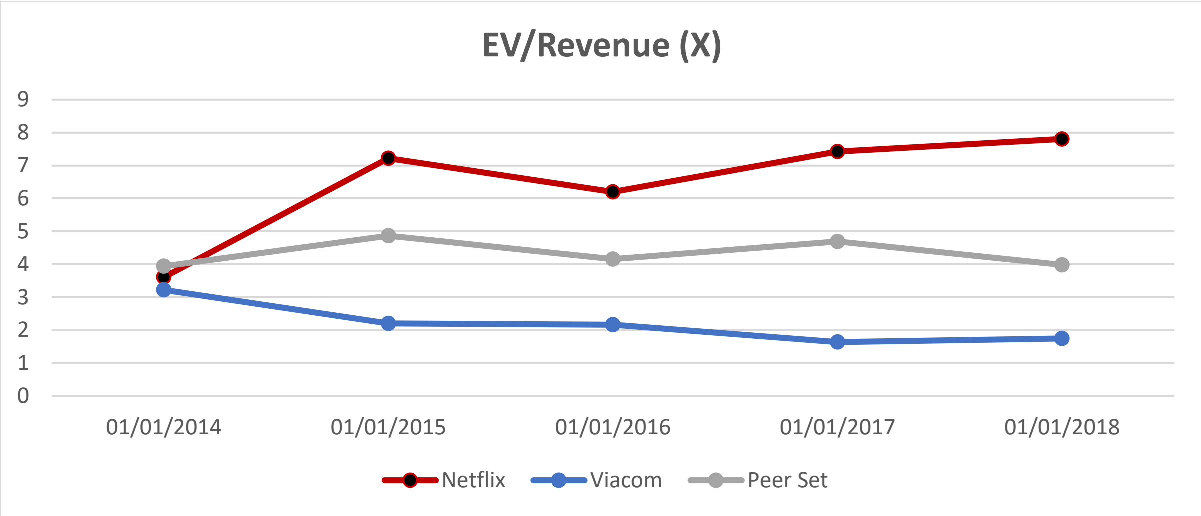
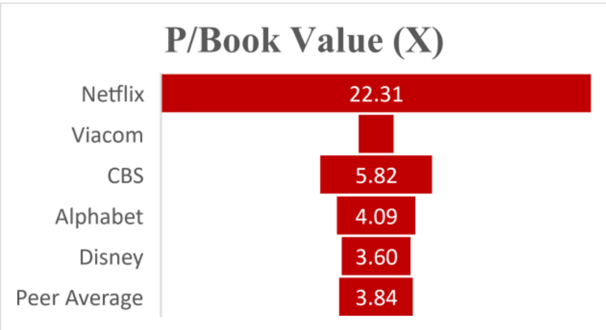
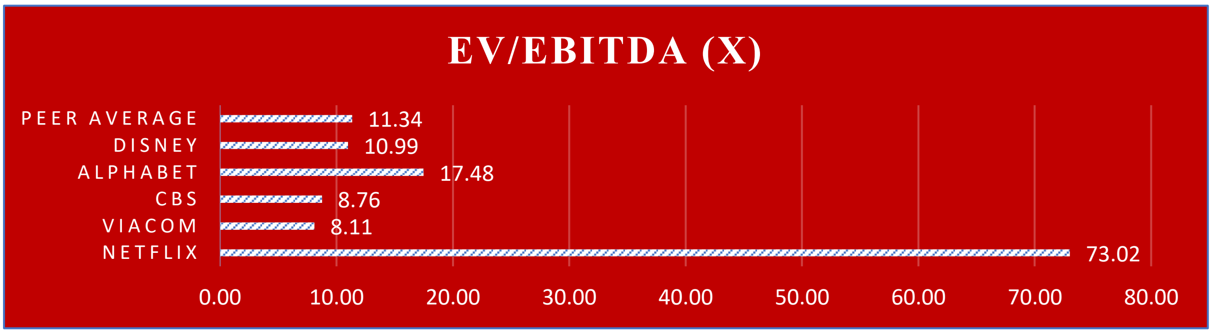


Figure 39. EV/Revenue



By conducting a comparable company analysis, we find some key points regarding the Netflix valuation. In 2014, total subscribers exceeded forecasts by more than 30%, reaching revenue of $1.3 billion. Reflected by their continuously higher valuation compared to their revenue, with a multiple nearly doubling the peer set. They also demonstrate a considerably lower EBITDA compared to their valuation as seen by the multiple which is 9 times the multiple of their peer Viacom.



Analyst Recommendation

Moderate Buy

- ❖ The industry is growing and prolific, Netflix is a strong player with an above-average enterprise valuation.
- ❖ The company has forecasted growth in years to come, and scope to improve their margins in the international market segment
- ❖ As seen by the financials and cash flows of Netflix, we recommend an overweight instead of a straight buy as we question the sustainability of high leverage operations in relation to their performance.
- ❖ Finally, new entrants in the market pose a threat to Netflix's service for the first time, therefore we advise the investor to be aware of potential downfalls in stock price.

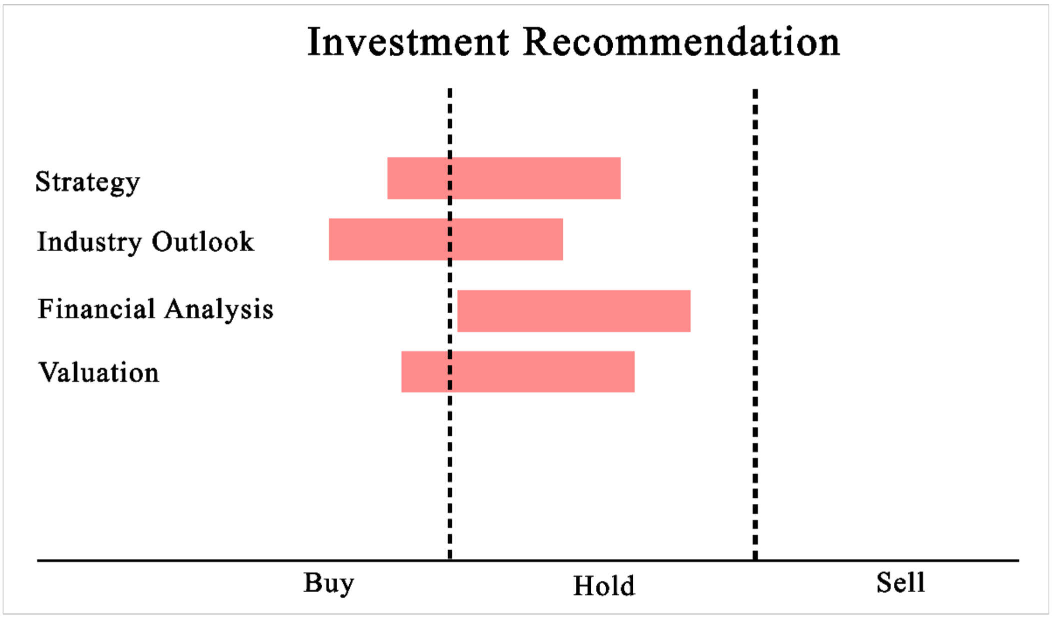


Figure 40. Investment Recommendation

Appendix

Projections - Upside Case							
			Calendar Year Ending 31st December, $m				
			2019	**2020**	**2021**	**2022**	**2023**
Sales	*%YoY*	*25.99%*	22858.78701	33082.997	47880.262	69296.004	100290.52
Cost of Sales	*%Sales*	*65.99%*	15083.9	21830.5	31594.8	45726.4	66178.8
Gross Profit			**7774.9**	**11252.5**	**16285.5**	**23569.6**	**34111.7**
Operating Expenses	*%Sales*	*25.60%*	5851.8	8469.2	12257.3	17739.7	25674.2
Operating Profit			**1923.1**	**2783.3**	**4028.2**	**5829.9**	**8437.5**
Interest	*%Sales*	*2.10%*	480.0	694.7	1005.5	1455.2	2106.1
Profit before Tax			**1443.1**	**2088.5**	**3022.7**	**4374.7**	**6331.4**
Tax		*0.10%*	1.4	2.1	3.0	4.4	6.3
Net Income			**1441.6**	**2086.5**	**3019.7**	**4370.3**	**6325.0**

Projections - Base Case							
			Calendar Year Ending 31st December, $m				
			2019	**2020**	**2021**	**2022**	**2023**
Sales	*%YoY*	*25.99%*	19970	25248	31923	40361	51031
Cost of Sales	*%Sales*	*65.99%*	13177	16661	21065	26633	33674
Gross Profit			**6792**	**8588**	**10858**	**13728**	**17357**
Operating Expenses	*%Sales*	*25.60%*	5112	6464	8172	10332	13064
Operating Profit			**1680**	**2124**	**2686**	**3396**	**4293**
Interest	*%Sales*	*2.10%*	419	530	670	848	1072
Profit before Tax			**1261**	**1594**	**2015**	**2548**	**3222**
Tax		*0.10%*	1.3	1.6	2.0	2.5	3.2
Net Income			**1259**	**1592**	**2013**	**2545**	**3218**

Forecasted Condensed Income Statements

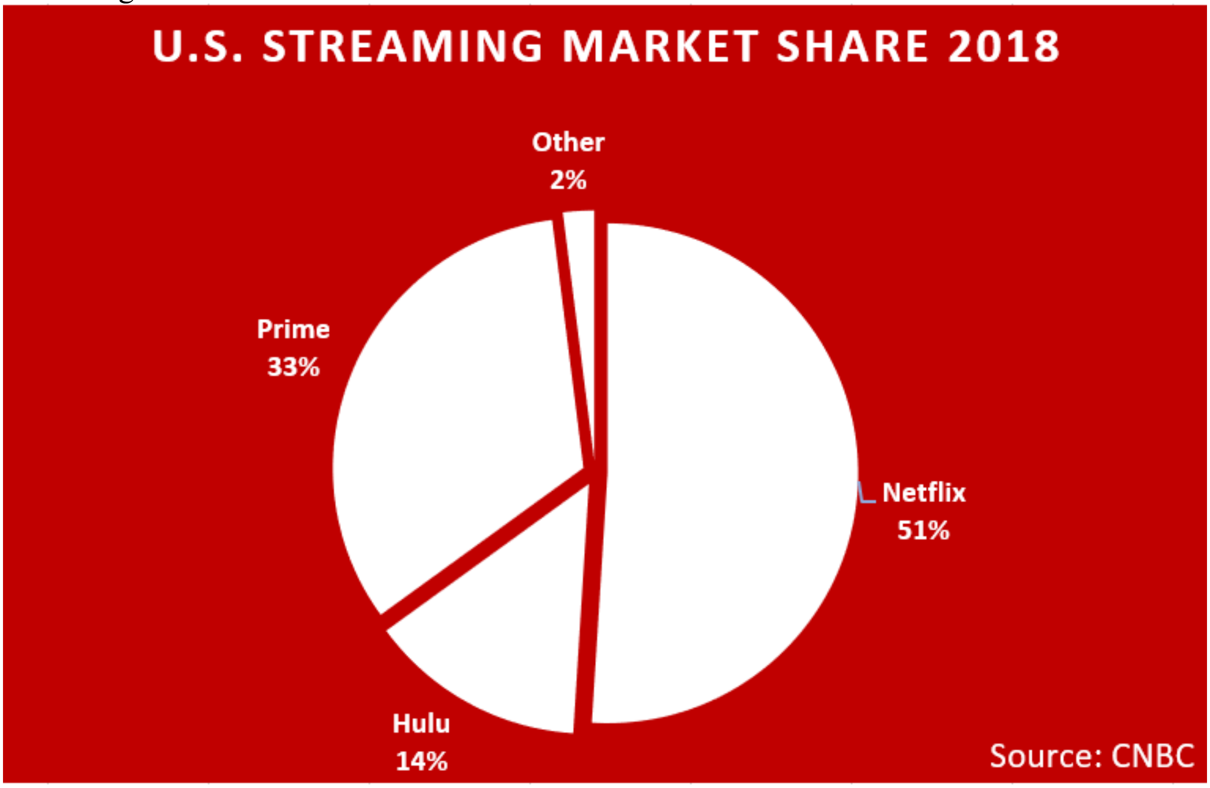
Projections - Downside Case

			Calendar Year Ending 31st December, $m				
			2019	**2020**	**2021**	**2022**	**2023**
Sales	*%YoY*	*25.99%*	18047.44251	20621.954	23563.727	26925.15	30766.089
Cost of Sales	*%Sales*	*65.99%*	11909.0	13607.8	15549.0	17767.1	20301.7
Gross Profit			**6138.5**	**7014.1**	**8014.7**	**9158.0**	**10464.4**
Operating Expenses	*%Sales*	*25.60%*	4620.1	5279.2	6032.3	6892.8	7876.1
Operating Profit			**1518.3**	**1734.9**	**1982.4**	**2265.2**	**2588.4**
Interest	*%Sales*	*2.10%*	379.0	433.1	494.8	565.4	646.1
Profit before Tax			**1139.3**	**1301.9**	**1487.6**	**1699.8**	**1942.3**
Tax		*0.10%*	1.1	1.3	1.5	1.7	1.9
Net Income			**1138.2**	**1300.6**	**1486.1**	**1698.1**	**1940.3**

Ratios:

	Netflix Inc.	Viacom	CBS	Walt Disney	Alphabet Inc.
Profitability (in %)					
Gross Margin	36.89	46.85	37.23	44.94	56.48
EBITDA Margin	10.69	21.50	20.61	29.97	25.84
Profit Margin	7.67	13.28	13.50	21.20	22.46
Management Efficiency Ratio (in %)					
Return on Equity	27.46	21.14	81.97	23.42	18.62
Return on Assets	5.38	6.60	9.18	11.09	14.29
Efficiency Ratios (multiple)					
Asset Turnover	0.70	0.57	0.68	0.60	0.64
Liquidity Ratios (multiple)	0.58	0.38	0.07	0.23	3.15
Cash Ratio					
Current Ratio	1.49	1.50	1.48	0.94	3.92
Leverage Ratios (multiple)					
Total Debt to Total Equity	197.76	130.75	362.05	38.71	2.26
Total Debt to Total Assets	39.89	42.39	46.44	21.18	1.72
Free Cash Flow to Total Debt	-0.28	0.21	0.12	0.46	5.69
Coverage Ratio (multiple)					
Capitalization Ratio	66.42	55.24	77.15	24.05	2.21
Valuation Ratios (multiple)					
P/E	132.32	6.51	8.85	15.97	n/a
Enterprise Value / EBITDA	95.59	7.53	9.18	12.64	n/a

Streaming Market Share in U.S. Market



Viacom Z-Score Breakdown

```
X1 = Working Capital                               / Total Assets
   = (Total Current Assets - Total Current Liabilities) / Total Assets
   = (5036 - 3833)                                 / 22744
   = 0.0529
```

```
X2 = Retained Earnings / Total Assets
   = 18916             / 22744
   = 0.8317
```

```
X3 = Earnings Before Interest and Taxes  / Total Assets
   = (Pre-Tax Income + Interest Expense) / Total Assets
   = (1845 + -540)                       / 22744
   = 0.1049
```

```
X4 = Market Value Equity / Book Value of Total Liabilities
   = Market Cap (M)      / Total Liabilities
   = 11335.659           / 15020
   = 0.7547
```

```
X5 = Revenue / Total Assets
   = 12960   / 22744
   = 0.5698
```

Netflix Z-Score Breakdown

```
X1 = Working Capital                                / Total Assets
   = (Total Current Assets - Total Current Liabilities) / Total Assets
   = (9694.135 - 6487.32)                           / 25974.4
   = 0.1235
```

```
X2 = Retained Earnings / Total Assets
   = 2942.359          / 25974.4
   = 0.1133
```

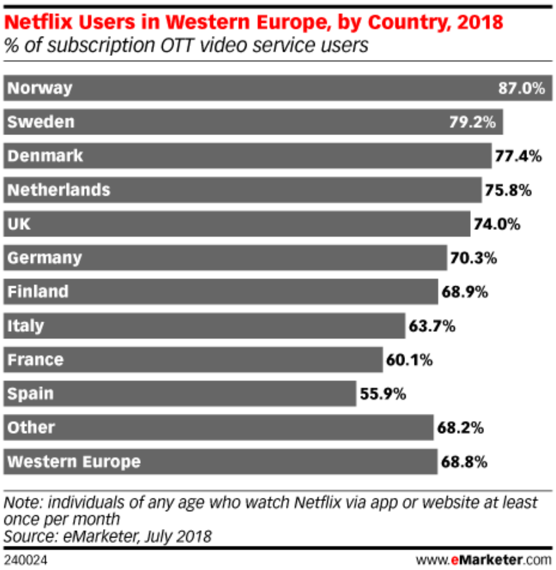
```
X3 = Earnings Before Interest and Taxes  / Total Assets
   = (Pre-Tax Income + Interest Expense) / Total Assets
   = (1226.458 + -420.493)               / 25974.4
   = 0.0634
```

```
X4 = Market Value Equity / Book Value of Total Liabilities
   = Market Cap (M)      / Total Liabilities
   = 154822.228          / 20735.635
   = 7.4665
```

```
X5 = Revenue    / Total Assets
   = 15794.341 / 25974.4
   = 0.6081
```

Suggested Peer Set Comparison

Suggested Peers		
BI NA Large Entertainment Content Valuation (Analyst Curated)	BICS (Best Fit Algorithm)	FAANG
Walt Disney	Snapchat	Facebook
CBS	Facebook	Apple
Discovery	Twitter	Amazon
Viacom	Alphabet	Netflix
		Google



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